1.04 Fair Value Measurement

Overview

ASC 820 defines the term *fair value (FV)* for financial reporting purposes, describes the various methods by which fair value can be measured for an asset and for a liability, and indicates the disclosures that are required to be provided when items are reported at fair value on the F/S. This section of the ASC does not allow, nor require, assets or liabilities to be reported at fair value unless there is another requirement to do so.

Items Required to be Reported at Fair Value

An entity is required to recognize various items at fair value, including the following:

- Investments in **marketable debt securities** that are classified as either **trading** securities or **available-for-sale (AFS)** securities are reported at fair value (ie, *marked to market*) as of each balance sheet date.
- Investments in **equity securities,** except those accounted for under the equity method; those required to be consolidated; and, when an appropriate election is made, those for which the market value is not readily determinable.
- With very few exceptions, **assets acquired** and **liabilities assumed** in a **business combination** are initially recognized at fair value, but are not adjusted to fair value in subsequent periods for presentation on the balance sheet unless that asset/liability is being reported at fair value for some other reason.
- **Impairment losses** result in the reduction of an asset's carrying value to its fair value in the period of the impairment.
- All **derivatives** are reported at fair value, *except* for interest rate swaps that are hedges when the alternative accounting approach available to nonpublic entities is elected.

Fair Value Definition

ASC 820 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." For a transaction to be orderly, it cannot be a forced transaction. Instead, the asset or liability is assumed to be exposed to the market for a time period that is customary for that type of asset or liability. **Market participants** are parties that are:

- Independent of the entity
- Reasonably knowledgeable about the asset or liability
- In a position to acquire the asset or assume the liability
- Voluntarily willing to acquire the asset or assume the liability

Note that the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (ie, the ***exit price****), not the price that would be paid to acquire the asset or received to assume the liability (ie, the* ***entry price****).*

Determining Fair Value

Assets, other than financial assets, are measured on the basis of their "highest and best use." Some assets are more valuable **in exchange** and are measured at what would be received upon their sale. Others are more valuable **in use** and are measured at the value represented in the form of some combination of potential revenues earned and cost savings that result from their use.

- It is assumed that a transaction will occur in the **principal market** in which the asset or liability would most frequently be traded.
- When there is no principal market, values are based on the assumption that a transaction would occur in the **most advantageous** market.

This is intended as a measure of an asset's or liability's fair value without assuming that the asset will actually be disposed of or the liability transferred. As a result, the value is determined without taking into consideration costs of the transaction, such as costs to transfer the asset or liability. If an asset (eg, a commodity) needs to be transported to its principal market, however, the cost of doing so is considered when measuring the asset's fair value.

Three Valuation Techniques (MIC)

- The **market approach** involves using information generated by market transactions that involve identical or comparable assets or liabilities.
- The **income approach** involves analyzing future amounts in the form of revenues, cost savings, earnings, or some other item.
- The **cost approach** involves measuring the cost that would be incurred to replace the benefit derived from an asset.

Three Levels of Inputs

- **Level I**, the most reliable, involves the use of observable data from actual market transactions, occurring in an active market, for identical assets or liabilities.
- **Level II** also involves the use of observable data from actual market transactions but *either*:
  - The transactions did not occur in an active market, *or*
  - The transactions relate to similar, but not identical, assets or liabilities.
- **Level III** involves the use of unobservable data and are largely based on management's judgment.

Practical Expedient for Certain Equity Interests

In some cases, an entity will have an equity interest in an entity that reports its net asset value per share. As a practical expedient, such an investment may be reported at the published net asset value per share.

- Since the fair value is not determined using a technique designated by standards for doing so, the fair value measurement does not fit into the hierarchy.
- As a result, an entity applying the practical expedient is not required to disclose the level of inputs that were used to determine fair value.

Steps to Fair Value Measurement

Fair value measurement may be applied using the following approach:

1. Identify the asset or liability to be measured.
2. Determine the principal or most advantageous market (*highest and best use*).
3. Determine the valuation premise (*in-use or in-exchange*).
4. Determine the appropriate valuation technique (*market, income, or cost approach*).
5. Obtain inputs for valuation (*Level 1, Level 2, or Level 3*).
    - Fair value hierarchy must be used to prioritize the inputs to valuation techniques.
6. Calculate the fair value of the asset.

Disclosures

Disclosures about the use of fair value to measure assets and liabilities should provide F/S users with better information about:

- The valuation techniques and inputs that the entity uses to arrive at its measures of fair value, including judgments and assumptions made
- The uncertainty in the fair value measurements as of the reporting date
- The effect of changes in fair value measurements on entity performance (ie, earnings or changes in net assets) and cash flows

In developing ASC 820, the Board considered the need for increased **consistency** and **comparability** in fair value measurements and for expanded disclosures about fair value measurements. Some of the required disclosures include:

- Identification of which items are reported at fair value and where they can be found in the F/S
- The level of inputs (I, II, or III) that were applied in measuring fair value
- The valuation technique applied (market, income, or cost)
- The disposition of changes in fair value (income or comprehensive income)

Fair Value Option

In addition to those items that are required to be measured at fair value, ASC 825 allows an entity to **elect** to report some or all of its financial instruments (aka, financial assets and liabilities) at their fair values. A **financial instrument** is defined as *cash*, evidence of an *ownership interest* in an entity, or a *contract* that *both*:

- Imposes on one entity a contractual **obligation** either:
    - To deliver cash or another financial instrument to a second entity
    - To exchange other financial instruments on potentially unfavorable terms with the second entity
- Conveys to that second entity a contractual **right** either:
    - To receive cash or another financial instrument from the first entity
    - To exchange other financial instruments on potentially favorable terms with the first entity

Examples of financial assets and liabilities that would qualify for the fair value option include:

- Most investments that do not already require FV measurement, such as investments accounted for under the equity method.
- Firm commitments involving financial instruments, such as forward exchange contracts to purchase or sell a foreign currency.

Certain items have their own established accounting principles, which are required to be followed. These items may involve measurements at fair value, but they **do not qualify** for the "fair value option" election:

- Pension plan, post-retirement, and other post-employment benefits (ASC 712 and 715)
- Leases (ASC 842)
- Financial instruments that are components of equity (ASC 505)
- Share-based payments and stock options (ASC 718)

If an entity decides to elect the fair value option, it may apply it to any qualifying financial instrument, without being required to apply it to others, including those that are similar. An election may be made only when a financial asset or liability is acquired, or in other limited circumstances, referred to as election dates. Likewise, once elected, the fair value option is permanent and may only be discontinued on a subsequent election date.

When the fair value option is elected, **unrealized gains and losses are reported in income.**